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Taxation - Valuation of Securities in a Close Corporation for Federal Estate Tax Purposes

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COMMENT

TAXATION—VALUATION OF SECURITIES IN A CLOSE CORPORATION FOR FEDERAL ESTATE TAX PURPOSES.

The purpose of this comment is to set forth the various methods of valuing stock in a close corporation for Federal Estate Tax purposes. It must be stressed at the outset that there is no one answer in this area; each situation demands its own analysis. In order to facilitate discussion of the problem a hypothetical corporation will be created. By working with this practical tool, the problems and modes of valuation might better be understood by the reader. Our factual situation will of course be related to and controlled by the Internal Revenue Code of 1954, the Internal Revenue Service Regulations and Tax Bulletins, and those court decisions which are pertinent to the topic at hand. If this presentation examines these in such manner as to aid practitioners with their evidentiary problems in particular cases, it will have accomplished its purpose.

I.

COURTS AND PROCEDURE.

At this point it would be prudent to consider the possible litigation and relevant procedure which might result from a difference of opinion between the Internal Revenue Service and the attorney for the estate. Generally, after all means of consultation have failed, the attorney has his choice of three courts in which to contest a deficiency assessment by the Service: the Tax Court, a United States District Court, or the Court of Claims.[1] The Tax Court is the only one of the three in which the estate can challenge the deficiency without paying the tax.[2] An action in a United States District Court or the Court of Claims is one for a refund.[3] The attorney's choice of forum is a significant one. If he thinks a jury is desirable, then a District Court should be his choice because only there may a jury trial be had.[4] As will later be demonstrated, factual determinations play a large role in the valuation action.

1. INT. REV. CODE OF 1954, § 7422.
2. INT. REV. CODE OF 1954, § 6213(a).
3. INT. REV. CODE OF 1954, § 7422.
4. 28 U.S.C. § 2402 (1948).

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The burden of proof in any litigation before the courts rests with the taxpayer; he must overcome the valuation set by the Commissioner.[5] When the claim is for a refund, the estate must show that not only the Commissioner's valuation is wrong, but also that its own valuation is correct.[6] Valuation testimony by experts may be most important, but it is not necessarily determinative.[7] The problem of choosing a tribunal is actually a separate topic and is mentioned here only as background material for the topic under consideration.[8]

II.

THE REVENUE CODE AND ITS REGULATIONS.

The Internal Revenue Code of 1954, § 2031(b) states:

> (b) Valuation of Unlisted Stock and Securities—
>
> In the case of stock and securities of a corporation the value of which, by reason of their not being listed on the exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of the stock or securities of corporations engaged in the same or a similar line of business which are listed on the exchange.[9]

It can clearly be seen that unless stock has recently been sold or a similar company listed on an exchange can be found, valuation for practical purposes remains a puzzle.

The Regulation pertaining to the provision in question contains eight subsections; the first is general in nature, and each of the others is devoted to a different approach to valuation.[10] The second of these (subsection (b)) speaks of valuation based on selling prices. This, of course, has reference to those securities listed on an exchange or dealt with in the market by over-the-counter sales. The third subsection is applicable only if the second is not. Here valuation is determined by the bid and asked prices which were tendered before and after the valuation date.[11] The prices must have been bona fide and made within a reasonable time of that date. The fourth subsection also deals with bid prices and again

5. Forbes v. Hassett, 124 F.2d 925 (1st Cir. 1942); Estate of Frank L. Gray, 10 CCH Tax Ct. Mem. 741 (1951); Estate of Thomas R. Tenant, 8 CCH Tax Ct. Mem. 143 (1949).

6. Worcester County Trust Co. v. Commissioner, 134 F.2d 578 (1st Cir. 1943); First Nat'l Bank v. Allen, 47-1 U.S. Tax Cas. ¶ 10,557 (M.D. Ga. 1947), *aff'd*, 169 F.2d 221 (5th Cir. 1948); Krauss v. United States, 51 F. Supp. 388 (E.D. La. 1943), *aff'd*, 140 F.2d 510 (5th Cir. 1944).

7. Michigan Trust Co. v. United States, 58-2 U.S. Tax Cas. ¶ 11,819 (W.D. Mich. 1958); F. J. Wood v. United States, 29 F. Supp. 853 (Ct. Cl. 1939); Estate of Elizabeth A. Wilson, 10 CCH Tax Ct. Mem. 750 (1951).

8. HARRIS, HANDLING FEDERAL ESTATE TAXES (1959).

9. INT. REV. CODE OF 1954, § 2031(b).

10. Treas. Reg. § 20.2031-2 (1954).

11. The Internal Revenue Code gives the taxpayer the choice of an alternate valuation date under certain circumstances. INT. REV. CODE OF 1954, § 2032.

is only applicable if the previous two are not. It provides for an average bid price where the bids occur *only* before or *only* after the valuation date. In such cases, the bids nearest the valuation date are given the greatest weight. The so-called "blockage" rule is set out in the fifth subsection. It provides that the size of the block of securities for sale is to be considered to determine whether or not the listed price on the stock exchange represents the fair market value. It is possible that a large block could not be liquidated without causing a decrease in the stock's market value. On the other hand, it would not be unreasonable to expect an increase in that value should the block be a controlling interest. Again, this subsection is applicable only if the previous subsections are not. In most close corporation situations none of the above subsections can be applied. It is the sixth one, subsection (f), that is most significant; this alternate method of valuation is based upon the actual business worth of the security. That is found through a business evaluation of the corporation's financial position, both former and prospective. In such a case the particular industry as a whole must be investigated, and the facts presented by each side are determinative. (Here the possibility of a jury trial should be remembered.) The last three subsections of the Regulation deal with the specific problems of pledged securities, options to purchase, and "ex-dividend" matters.[12]

It should be noted that the valuation of closely held stock is a procedure not restricted to the area of federal taxation; the states are equally concerned. Furthermore, since the state courts have complete jurisdiction over their own tax cases,[13] it is possible for a state court to allow a valuation which has been rejected by a federal court,[14] and visa versa.[15] In some cases the state court's acceptance of a particular valuation has been introduced as evidence to establish the value of the asset.[16] There has also arisen on the state level a significant problem in the valuation of dissenting stockholders, shares under an appraisal statute.[17] In such cases, the intracorporation conflict, which, for example, might center around a proposed merger, and which may be resolved by having a court appraise the stock, is merely a skirmish compared to the major battle which may later develop over what is the "fair market value" of the minority's interest, especially where the corporation is the close or family type.[18] This same problem is faced on the state level when there is a statutory provision which permits avoidance of a shareholder deadlock by granting to the majority the right to buy out the minority's interest.[19]

12. Treas. Reg. § 20.2031-2 (g), (h), (j).
13. First National Bank of Memphis v. Commissioner, 125 F.2d 157 (6th Cir. 1942); T. I. Hare Powell, 10 B.T.A. 166 (1928).
14. T. I. Hare Powell, *supra* note 13.
15. First National Bank of Memphis v. Commissioner, *supra* note 13.
16. Mary M. Buck, 25 B.T.A. 780 (1932); Estate of Alfred D. Kaufmann, 11 B.T.A. 412 (1928).
17. Note, 60 YALE L.J. 337 (1951).
18. Note, 23 MO. L. REV. 223 (1958).
19. CAL. CORP. CODE § 4658; W. VA. CODE ANN. § 3093 (1961); HENN, CORPORATIONS § 280 (1961).

III.

GARDEN-TOOLS, INC.

The facts which will be assumed for purposes of this analysis are the following. The name of our self-created corporation is Garden-Tools, Inc. It was started by Mr. Scott E. Williams in 1923 as the Garden Company, a sole proprietorship. In 1946, because of certain tax advantages, it was thought best to incorporate, using the name Garden-Tools, Inc. The stock of the corporation was owned by Mr. Williams (500 shares), Scott E. Williams, Jr., his son (250 shares), and Mary R. Williams, his daughter (250 shares). The assets of the corporation are now $1,250,000; they consist, in part, of a factory worth $450,000 with an expected life of twenty-two years and equipment valued at $350,000 with an expected seven year life. The corporation manufactures garden tools of all varieties. The net worth of the company is $750,000, of which $420,000 represents capital stock, and the rest is retained earnings. Earnings since World War II have been going steadily upward, and in the last five years the company has had an annual net income of at least $75,000, with a high in 1961 of $94,000. Originally the garden tool industry was non-competitive in nature, but now the large discount houses manufacture their own brands and sales are limited to medium and small retailers. Garden-Tools, Inc. has dropped in market control from 8% in 1950 to 5½% in 1960, but it still retains more control in the Eastern area than any other corporation with only one class of stock. Mr. Williams, Sr. is the president of the corporation and receives a salary of $60,000 a year. Scott, Jr. is the vice-president in charge of sales and receives $37,000 a year. There are no bonus plans in effect for any executive officers. The corporation has paid dividends at the rate of 8% a year since its inception. A first refusal option agreement among the shareholders gives them the first option to buy the stock of any shareholder who dies or who wishes to sell his stock. The price, based upon market value, is determined by a board of appraisers. The only other pertinent fact is that Garden-Tools, Inc. apparently owns the rights to a manufacturing process by which the handles of the tools are forged to the heads. However, these rights are currently the subject of a patent infringement suit. Mr. Williams died on December 3, 1961, and the attorney for the estate is now concerned with the valuation of the decedent's stock for Federal Estate Tax purposes.

There is no question that Garden-Tools, Inc. is a close corporation. The definition of such an entity is not set down by either the Code or the Regulations. However, the Internal Revenue Bulletin of 1959 does offer the following:

> .03 Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this

> situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the terms "fair market value."[20]

The English definition of a close corporation, namely, one "which fills its own vacancies," was rejected in 1935.[21]

Until the death of the founder, Scott Williams, Sr., no one but members of the family owned stock in Garden-Tools, Inc. The stock was never involved in any type of sale nor placed on any stock exchange. This would seem to eliminate any possible valuation under the first five subsections of Regulation 2031-2, since each is based on selling price or bids. Thus, subsection (f) is the one with which we must work.

IV.

THE BUSINESS EVALUATION.

As has previously been emphasized, subsection (f) provides that the financial status of the corporation can be employed as an adequate measure of the value of the securities. To determine that status, however, one must examine those factors which shed light upon the business history and outlook of the corporation in question. It is the purpose of the presentation that follows to engage in such an examination with a view toward arriving at a method of valuation which could practically be applied to Garden-Tools, Inc.

A.

Balance Sheets And Net Worth.

The examination will start with the *general* financial position of the corporation as seen through an analysis of its balance sheets. Such an analysis must be made by a financial expert[22] who would compare the corporation's balance sheets for the past few years.[23] From the latest such statement one could formulate a working capital ratio, i.e., a ratio of current assets to current liabilities. Such a ratio would be an aid in determining which assets could be readily converted into cash at a time of need.[24] In certain situations the court may determine the market value of the assets and impute that value to the stock. Such a case would arise if the shareholders have dealt with the corporation in such a way as to decrease its real income, e.g., by interest free loans or by padding

20. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.
21. Brooks v. Willcuts, 78 F.2d 270, 273 (8th Cir. 1935).
22. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.
23. Schnorbach v. Kavanagh, 102 F. Supp. 828 (W.D. Mich. 1951); Estate of Reuben J. Freed, 6 CCH Tax Ct. Mem. 216 (1947); Estate of Henry E. Huntington, 36 B.T.A. 698 (1937).
24. Bader v. United States, 172 F. Supp. 833 (S.D. Ill. 1959).

the corporate expenses with those of a personal nature.[25] Where it appears that there have been "under the table" dealings with the corporation, the valuation set by the Commissioner is difficult to overcome. One of the simplest methods of valuing stock is to divide the net worth (the sum of the capital and earnings accounts) by the total number of shares. A "book value" is thereby given to the securities.[26]

Garden-Tools, Inc. is surely a going concern out to make an income. While it is true that it was brought into existence to take advantage of certain tax benefits, there were no "under the table" dealings with the corporation by its shareholders. The attorney for the estate should secure a complete analysis of the balance sheets as the first step toward determining the financial position of the corporation. As a general rule, however, such an analysis is but one factor to be considered in the process of valuing the stock.

B.

Dividends.

When dividends are used as criteria in valuation, it matters not how much has been paid, but most important is the corporation's capacity for paying.[27] Clearly, some of the income of the corporation must be retained for the company's use. A dividend payment policy may serve to attract potential investors to the corporation because of a high dividend rate, a consistent declaration of payments, or by an indication that the trend is toward higher payments in the future. In a family type corporation, however, dividend payments can be a most unreliable indicator of valuation; the corporation is not at all interested in encouraging prospective investors and finds it easy to pay salaries and/or bonuses in substitution for dividends.[28] Nevertheless, in those cases where dividend payments have been fairly steady, it has been held that the company's dividend policy is to be considered a part of the process of valuation.[29]

The Garden-Tools company has been paying low but steady dividends. While two of its stockholders are salaried employees, their salaries are not excessive in light of their positions. In such a case, dividends merely reflect the liquid state of the corporation and would probably be considered with earnings.

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25. Hamburger v. Commissioner, 166 F.2d 422 (9th Cir. 1948); Weber v. Rasquin, 23 F. Supp. 523 (E.D.N.Y. 1938); Estate of H. W. Hammond, 13 CCH Tax Ct. Mem. 903 (1954), *modified on other grounds,* 18 CCH Tax Ct. Mem. 83 (1955).

26. True v. United States, 51 F. Supp. 720 (E. D. Wash. 1943); Estate of Reuben J. Freed, *supra* note 23; Mary A. B. DuPont Laird, 38 B.T.A. 926 (1938).

27. Bader v. United States, *supra* note 24; Schnorbach v. Kavanagh, *supra* note 23; Colonial Trust Co. v. Kraemer, 63 F. Supp. 866 (D. Conn. 1945).

28. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.

29. Colonial Trust Co. v. Kraemer, *supra* note 27; Blackard v. Jones, 62 F. Supp. 234 (W.D. Okla. 1944).

C.

Business Outlook.

The business outlook of the particular corporation and of its sector of the business community in general is perhaps the most significant factor to be considered in the proof or disproof of a Commissioner's valuation. Where the company has been having constant deficits in its earnings, although its net worth may still be large, it might be shown that the company is no longer in a favorable position and is headed for ultimate wreckage. In one case, the taxpayer tried to show that not only was the corporation headed for ruin, but that since the estate was a minority stockholder it was powerless to force a liquidation.[30] It was also claimed that there could be no fair market value because no market existed, especially for a large block of stock. The Commissioner countered by saying that the other owners of the stock could change their policy of holding the real estate and, further, that there is always the possibility that the land value will increase. The taxpayer cited the cost of liquidation in time and money as a factor which itself effects a decrease in value, but the court held that in order to overcome the Commissioner's case the amount of the reduction had to be shown. In *Horlik v. Kuhl*,[31] an increase of competition in the industry in which the close corporation had formerly occupied a dominant position, was held by the court to be a fact for consideration in assessing the value of the corporation's shares. In that case the company had suffered losses in its last ten years and was trying desperately to meet the lower prices of its competitors.

Where the stock to be valued is that of a holding company, there is, in a sense, a more subtle process of evaluation. The position and prospects for such a company are determined by thoroughly analyzing the potential of those firms in which the company holds an interest.[32]

An examination of Garden-Tools, Inc. should serve to illustrate the typical analysis made under similar circumstances. The corporation is relatively young, but the single proprietorship which preceded it had been in operation for over twenty years. While in the early days Mr. Williams had the field to himself, competition has recently increased as the tool industry has grown. Thus, although the income of the corporation is rising, its percentage of the market has steadily decreased from eight per cent in 1950 to five and one-half per cent in 1960. There is also the question of the patent infringement suit. Not only could a great deal of money be lost in the action, but a very valuable part of the company's product might become unavailable. Since all of these facts would be pertinent in any process of security valuation, it would be well for an

30. Forbes v. Hassett, 124 F.2d 925 (1st Cir. 1942).

31. 62 F. Supp. 168 (E.D. Wis. 1945).

32. Goss v. Fitzpatrick, 97 F. Supp. 765 (D. Conn. 1951); Estate of Jessie Ring Garrett, 12 CCH Tax Ct. Mem. 1143 (1953); Estate of Lloyd R. Smith, 9 CCH Tax Ct. Mem. 907 (1950).

attorney for the estate to engage in a thorough analysis to ascertain their true significance.

D.

Earnings.

Among the most relevant factors to be taken into consideration in the valuation of stock in a close corporation are its earnings.[33] In order to determine the current value of the corporation's assets, the average annual corporate earnings for a period of years is multiplied by a certain factor. The factor reflects the rate of return which the assets can be expected to earn. Thus, if a ten per cent return were expected, the average annual earnings would be multiplied by ten; a twenty per cent return would require a multiplier of five. Usually, the per cent of expected return is between six and fifteen.[34] This method of computation is referred to as capitalization of earnings, and generally is used as a means of evaluating goodwill. The period over which the earnings will be averaged must be carefully chosen. It would be an invalid measure if it represented a time when earnings were extremely low or high. A period which included the early years of the corporation when the going is usually difficult would similarly present a somewhat distorted picture.

While the selection of the expected rate of return is generally conceded to be a question of fact, an appellate court will at times remand a decision to the lower court if it thinks an incorrect per cent was used.[35] The selection itself demands an examination of those factors which will be discuused in the balance of this comment.

Garden-Tools, Inc. has been in a stable position as regards its earnings. The company had bad years only during the second World War. Its earnings during the past ten years average over $75,000 a year. There would be no trouble in selecting a period of years since the level of earnings has been steady. The difficulty would be in finding a fair rate. Control of the market, business trends, competition, financial status, etc., would all be relevant in that determination.

E.

Comparison With Listed Companies.

A comparison with similar companies is specifically mentioned in the Internal Revenue Code of 1954.[36] Even prior to passage of that Code, it was held that such a comparison was a legitimate factor for considera-

33. Gould v. Granquist, 59-1 U.S. Tax Cas. ¶ 11,857 (D. Ore. 1959); Riley v. Meyers, 59-1 U.S. Tax Cas. ¶ 11,874 (N.D.N.Y. 1959); Tucker v. Commissioner, 54-2 U.S. Tax Cas. ¶ 10,956 (E.D. Ark. 1954).

34. Kline v. Commissioner, 130 F.2d 742 (3d Cir. 1942); Wishom v. Anglim, 42 F. Supp. 359 (N.D. Cal. 1941); Arthur L. Parker, 4 CCH Tax Ct. Mem. 449 (1945).

35. Snyder's Estate v. United States, 285 F.2d 857 (4th Cir. 1961).

36. INT. REV. CODE OF 1954, § 2031(b).

tion when computing the value of the stock of a close corporation.[37] Clearly, the problem in employing such a method is determining which of the listed corporations the one in question should be compared with. One customary approach is to match it up with those companies that control approximately the same percentage of the particular market.[38] The value of the stock of the chosen companies as quoted on the different stock exchanges will then be established as the close corporation's stock value. If some of the selected corporations have more classes of stock or have debentures, and the close corporation does not, a comparison would be misleading.[39] If the evaluation is to be made on the basis of financial position, *all* the records which might be relevant must be examined. A court may not consider any records not presented to it.[40] To secure the greatest weight, the listed corporations should be similar to the close corporation in many respects. If they are manufacturing companies, the same production methods, similar financial position and capital structure, plus like sales records, should be looked for.[41]

Garden-Tools, Inc. should try to avoid this test. Actually, none of its competitors is similarly situated. The large corporations listed on the exchange handle additional products; and the smaller ones, while they carry the same line, have much less market control. Thus, it would seem that in the instant case the attorney for the estate could easily undermine the position of the Commissioner should the latter choose to rely on this particular device in his valuation.

F.

History of the Corporation.

When using the history of a corporation to help determine the value of its stock, the evaluators are in effect employing a method which combines a number of the other tests, such as, earnings, dividends, business outlook, management, and the balance sheet. In a recent decision a federal district court sought to value the stock of a Missouri brewery.[42] In so doing it discussed the history of the brewery in detail, going back to its output of beer before Prohibition; the change over to "near beer" during Prohibition, which gave it a national distribution; its advantage over the other breweries when Prohibition was abandoned, which resulted from its only having to modify its brewing techniques in order to brew true beer; the period in the late thirties when the other breweries caught up; a World War II boom in sales caused by the national breweries having

37. Blackard v. Jones, *supra* note 29.
38. Haines v. United States, 188 F.2d 546 (9th Cir. 1951); John M. Aufiero, 13 CCH Tax Ct. Mem. 182 (1954); Estate of Lizzie Florence Olney, 5 CCH Tax Ct. Mem. 495 (1946).
39. Estate of Levenson v. Commissioner, 282 F.2d 581 (3d Cir. 1960).
40. Estate of Edgar F. Luckenbach, 17 CCH Tax Ct. Mem. 167 (1958).
41. Estate of Anna C. Ewing, 9 CCH Tax Ct. Mem. 1096 (1950).
42. First Trust Co. v. United States, 59-1 U.S. Tax Cas. ¶ 11,843 (W.D. Mo. 1958).

transportation troubles; the introduction of a new beverage, "malt liquor," in the early fifties after competition had set the brewery on a decline; and a decline again due to outmoded means of production in the middle fifties. The court recognized the economic fate of medium-sized breweries resulting from the increase in control of the market by the larger companies. It further considered the hurried and haphazard manner in which facilities had to be modified during Prohibition, as well as the government control which is always imminent in such an industry. The court thus reviewed the historical developments in an effort to predict the prospects for the future. It is reasonable to conclude that if a company has in the past faced business decline because of some factor such as remoteness to market or dependency upon another insecure company for business, the slide will continue unless checked by some unusual development.[43]

A close examination of the corporation's cyclical fluctuations with a view to the future would also be prudent. If these cycles follow a pattern which can be related to economic conditions as a whole, such an analysis could be most beneficial.[44]

An examination of Garden-Tools, Inc. relates a history of prosperity. Perhaps the most significant fact is again the decrease in the percentage of the market controlled by the corporation. If the decrease continues, so ultimately will the company's income. The equipment and buildings are in good shape; statistics indicate that the buildings have a life of twenty-two years, and the equipment has another seven years of productivity. It would seem that the history of Garden-Tools, Inc. does not at this time reveal any one fact which points to an imminent downward swing.

G.

Stock Purchase Agreements.

This valuation method is considered to be controlled by a Regulation,[45] but it nevertheless presents problems. If the stock purchase agreement is to determine the value of stock for Federal Estate Tax purposes, it is necessary that, by its terms, the decedent's power of sale during his lifetime be restricted to the one who has the option to purchase under the agreement.[46] From the standpoint of corporate control, such an agreement usually causes no problem. The other stockholders, or the corporation itself, are generally given the first option so that control can not pass to outsiders. Under state law, such restrictions are valid restraints on the sale of the shares.[47]

43. Estate of James D. McDermott, 12 CCH Tax Ct. Mem. 481 (1953).
44. Estate of Mary K. Miller, 18 CCH Tax Ct. Mem. 1127 (1959); John M. Aufiero, *supra* note 38; Estate of Allen R. Joslin, 5 CCH Tax Ct. Mem. 410 (1946).
45. Treas. Reg. § 20.2031-2(h).
46. Estate of Orville B. Littick, 31 T.C. 181 (1958); Estate of Albert L. Salt, 17 T.C. 92 (1951); see also Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955) (partnership case involving the same problem).
47. HENN, CORPORATIONS § 281 (1961).

While such a transaction must have been conducted at "arms length," it may fix the value of the stock even if the price agreed upon is below the present fair market value.[48] In one case, the agreed-upon formula resulted in no price having to be paid. The court nevertheless upheld the agreement saying that all the tests under the Regulation had been met.[49] If the court feels that the agreement is just a substitute for a testamentary disposition, it will not uphold that agreement's determination of the fair market value of the stock.[50] In some cases a court might hold the agreement not binding on the valuation question, but still consider it as evidence in deciding that question.[51] Even if such an agreement does not concern the decedent, but another shareholder in the same corporation, the court might look to it as possible evidence of valuation.[52]

In the agreement between Mr. Williams and the other shareholders, his son and daughter, none of the participants could sell his shares without first offering them to the others at a "fair market price." This price was to be determined by a board of appraisal consisting of the corporation's attorney, a real estate appraiser, and the accountants who handle the corporation's audit. It is clear that the Williams agreement met the requirements of the Regulation; however, that agreement calls for a valuation of its own. If the Commissioner should refuse to recognize such a valuation after the board of appraisal has taken the time and expense to formulate it, the estate would have to overcome the one set by the Commissioner. Rather than repeat the procedure it would seem more prudent for the estate to concentrate on one valuation based upon the factors discussed herein.

H.

Intangible Assets.

Intangible asset valuation is very difficult from the standpoint of strict appraisal. No one can figure exactly how much the goodwill nurtured through the years is worth to a company, or what is the actual value of the trade name. Nevertheless, it has been held that even though a binding option agreement may preclude the consideration of goodwill in the price of stock, the Commissioner is not prevented, for Federal Estate Tax purposes, from evaluating the shareholder's interest in the business so as to include goodwill.[53] This asset has been held relevant in the determination of the value of an interest in a partnership.[54] The pertinent

48. Estate of Orville B. Littick, *supra* note 46.

49. May V. McGowen, 194 F.2d 396 (2d Cir. 1952). It seems that in this case the stock could not have been sold for value anyway.

50. Estate of Orville B. Littick, *supra* note 46.

51. Krauss v. United States, 140 F.2d 510 (5th Cir. 1944); Baltimore National Bank v. United States, 136 F. Supp. 642 (D. Md. 1955).

52. Horlick v. Kuhl, 62 F. Supp. 168 (E.D. Wis. 1945); Belser v. Edwards, 54-1 U.S. Tax Cas. ¶ 10,942 (M.D. Ga. 1954).

53. Rev. Rul. 157, 1953-2 CUM. BULL. 255.

54. Estate of George Marshall Trammell, 18 T.C. 662 (1952).

Internal Revenue Ruling provides that any factors of an intangible nature, such as prestige or success in a locality, or trade names, which are supported by facts, can be considered when the stock is being valued.[55] This ruling also speaks of goodwill as being based upon the earning capacity of the corporation. Therefore, it might be said that if the rate of return on the tangible assets of the close corporation is high, that which represents an addition to the normal return can be attributed to goodwill.

Garden-Tools, Inc. carries no intangible assets on its balance sheet. Its trade name is of fairly recent origin. In fact, it was not used until the proprietorship became a corporation, and therefore is not so established as to have a value. The Commissioner might place a value upon the process which is under the exclusive control of Garden-Tools, Inc., *i.e.*, the forging of the handle and the head of the tool together. This process, however, is now the object of a law suit; to place a value upon it might be premature. The most significant factor of intangibility in this case is Garden-Tool's prominence in the locality. Its importance could no doubt be minimized, however, by noting the corporation's recent loss of market control.

I.

Blockage.

As has previously been noted, the blockage rule may give the taxpayer the benefit of a reduction in value. Since the Regulation deals in part with stock which represents a controlling interest,[56] it would seem that in most cases the special value which attaches to such an interest would have to be taken into consideration.[57] As a general rule, however, such a provision is operative only in those cases involving the sale of stock on the market; it has been held inapplicable to a close corporation since there is no ready market for the stock.[58] It is apparent, therefore, that while the Williams stock represents a substantial block, its value would be unaffected by the rule under discussion.

J.

Management.

The last factor for consideration is the significance of the corporate management. There can be no doubt of its relevance.[59] If a business is to compete and survive in a dynamic economy, the importance of its being directed with imagination and skill is evident. It is not difficult to conceive of a situation where the unavailability to a corporation of its prime mover in policy matters would result in that entity's demise. In such a circum-

55. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.
56. Treas. Reg. § 20.2031-2(e).
57. Helvering v. Safe Deposit and Trust Co., 95 F.2d 806 (4th Cir. 1938).
58. Schnorbach v. Kavanagh, *supra* note 23.
59. Campbell's Estate v. Kavanagh, 114 F. Supp. 780 (E.D. Mich. 1953).

stance, the effect upon the value of its stock would be obvious and would most certainly require that that fact be considered in any valuation procedure.[60]

Fortunately, Garden-Tools, Inc. was not a one man operation. The son had for many years been schooled in the company's workings, and there is nothing to indicate that he is not competent to fill the managerial position previously held by his father. The death of Mr. Williams should, therefore, have no substantial effect upon the corporation's future nor upon the value of its securities.

VI.

CONCLUSION.

Having concluded our review of the many factors which might be considered in the process of stock valuation, it should be evident that no set formula can be applied in every case. As a general rule, if any of these factors is introduced as evidence, it will be taken into consideration. In the case of Garden-Tools, Inc. an accurate valuation might be had by capitalizing the earnings. This method is quite commonly employed since it takes into account most of the factors about which we have spoken, including any intangible asset value which may be present. The annual income of Garden-Tools has consistently been about $75,000. Since there have been no substantial fluctuations, the problem of choosing the appropriate period of years is minor. The expected rate of return, however, may not be so easily determined. While six per cent is generally accepted as the average figure, our particular case demands its own analysis. In the preceding discussion it has been found that the earnings, the history, and the management of Garden-Tools would tend to increase the value of its stock. On the other hand, Garden-Tools' decreasing control over the market, and the infringement suit which threatens to deprive the corporation of a valuable manufacturing process, have the effect of deflating that stock's value. Upon balancing these considerations we might safely conclude that eight per cent is a true representation of the expected rate of return. By applying the formula previously stated, we arrive at a current corporate asset value of $937,500. It should be noted that this figure is between the book value of the stock, $750,000, and the carrying value of the assets, $1,250,000. To value the total corporate stock at that figure would, therefore, not be unreasonable.

While the capitalization of earnings has apparently yielded an acceptable valuation in this case, it must be emphasized that, given another fact situation, the approach might of necessity be substantially altered.

Edwin W. Scott

60. Estate of James D. McDermott, *supra* note 43.